Snohomish Busts Synthetic Rate Gone Awry as AIG Swaps Blow Up

By Peter Robison

April 21 (Bloomberg) -- Water and electric customers in the Seattle area, most of whom pay U.S. taxes, will pay an additional $14 million to get out of an agreement with **American International Group Inc.**, the insurance company rescued from insolvency in 2008 by American taxpayers.

The fee from the **Snohomish County Public Utility District**, serving Boeing Co. and 320,000 other electricity buyers, will settle a nine-month-old dispute with AIG, according to a copy of the accord obtained under state public records law. The municipal power company and AIG sued each other over a contract created in 1994 to help Snohomish reduce its borrowing costs by $2.9 million -- an early version of a financial derivative known as an interest-rate swap.

Snohomish is among at least 1,900 public institutions from Puget Sound to the Aegean Sea that sought to lessen interest expenses using similar agreements with potentially hazardous results. Harvard University in Cambridge, Massachusetts, paid more than $900 million to get out of swaps that backfired when interest rates unexpectedly plummeted, increasing its costs.

Borrowers have paid as much as $5 billion to Wall Street to exit swaps since 2008, according to **Peter Shapiro**, the managing director of Swap Financial Group LLC, an adviser in South Orange, New Jersey.

"There's a lot of so-called sophisticated stuff ginned up by the finance industry," said **William Kittredge**, a former utility director in Oregon who is now director of the nonprofit Center for the Study of Capital Markets and Democracy in Arlington, Virginia. "When you're talking about public money, it's not the way to go."

Exchanging Payments

In an interest-rate swap, parties exchange interest payments on a set amount of debt, often with the goal of locking in a fixed rate on a related set of variable-rate bonds. During the 2008 credit crisis, interest owed by local governments on floating-rate bonds exceeded payments they received under swap agreements.

Such "synthetic fixed-rate" deals pushed Jefferson County, Alabama, close to bankruptcy two years ago. It had refinanced $3 billion of debt with variable-rate bonds and purchased swaps to guard against borrowing costs rising. Its expenses soared when insurers guaranteeing the bonds lost their top credit grades, and the rate the county received fell.

'Reckless Traders'

The Snohomish **utility**, which faced increased swap-related payments of about $5 million a year, resisted paying to exit its contract for almost two years. In its suit against AIG, Snohomish alleged that a "now-infamous unit of reckless traders" had "drawn a bead" on the utility. In the end, Snohomish opted to pay the termination fee and sell 15-year bonds to replace all its floating-rate debt, said Jim Herrling, senior manager of risk management and supply for the utility. Those bonds sold yesterday at 3.18 percent.

Snohomish projects it will save $14,179,907.63 in budgeted interest costs over the life of the new debt, Herrling said. All but $133,782 of that will go to AIG in the termination payment.

That fee is enough to buy a new energy-efficient refrigerator for 11,864 homes, based on estimates from the U.S. government's **Energy Star** program. It amounts to about $43.75 for each Snohomish electric customer.

"The ratepayers I don't think are going to be paying any more in the long run," Herrling said. "They're just making this payment up front and we're reducing our future debt service payments between now and 2025."

"We're pleased that we have settled this matter," said **Mark Herr**, a spokesman for New York-based **AIG**, which is 80 percent owned by the U.S. government after a 2008 bailout. Neither party made any admission of liability in the settlement.

Battled Enron

The Snohomish utility, located in Everett, Washington, 30 miles north of Seattle, **unearthed** audiotapes of Enron Corp. traders discussing manipulating California power prices in 2004. Enron, the bankrupt energy-trading company, had sued Snohomish over canceled power contracts. The utility paid $18 million, 10 cents on the dollar, to settle the suit in 2007.

In 1994, Snohomish needed money to build transmission lines, replace electrical poles and add street lighting.

Jerry Bobo, a banker at the time for New York-based Smith Barney Inc., recommended borrowing $58.3 million for 30 years at floating rates, using a swap agreement to lock in a fixed rate lower than Snohomish could obtain by issuing conventional bonds. The savings might total $2.9 million, according to a Smith Barney presentation obtained by Bloomberg through state public records law. In 1998, Smith Barney became a unit of **Citigroup Inc.**, the bank rescued by taxpayers in 2008.

Reset Weekly

Rates on the debt, known as variable-rate demand bonds, would reset weekly. AIG agreed to accept a fixed 6.2 percent payment from Snohomish and pay the floating rate. A traditional fixed-rate bond at the time might cost the utility 6.95 percent, according to the bank's presentation.

Through today, that spread saved the utility more than $4 million, according to Anne Spangler, the general counsel for Snohomish.

The power company gave up something more valuable: the right to refinance the bonds without penalty if interest rates changed, said **Andrew Kalotay**, a former Salomon Brothers bond analyst who is now a consultant in New York. That created significant risk for the borrower over the contract's 30-year term, he said.

Kalotay compared it to a homeowner accepting a mortgage that would require extra charges in advance for refinancing. Private borrowers typically use swaps only to cover short-term rate movements of six months or less, he said.

Smith Barney's presentation to the Snohomish utility portrayed the longer term of the accord as a way to save money.

'No Significant Risks'

"The economics of a swap are such that the financial benefits of the transaction increase as the swap term increases," one slide said. Another mentioned that credit raters would view the structure as fixed-rate debt.

"The result: True Synthetic Fixed Rate Debt," the slide said. "No significant risks."

"They could have done the same thing much more cheaply by using plain-vanilla, fixed-coupon bonds," Kalotay said. "The swaps are a way for the banks to make a lot of money. Every 10 swaps municipalities enter into, nine of them turn out to be completely inappropriate."

The floating-rate debt stood to make Smith Barney more in fees. Bobo acted as salesman and adviser as the utility debated the transaction. Then, his bank served as both underwriter and "remarketing agent," responsible for setting weekly interest rates once the floating-rate debt was sold.

Additional Fee

That last duty earned a fee: 0.1 percent a year, or $1.7 million over the life of the bonds, according to documents presented to Snohomish officials. Those terms helped the bank earn more than double what it would have underwriting a traditional fixed-rate bond, the documents show.

Bobo, who has an office in Seattle, didn't return telephone calls seeking comment. Citigroup spokesman **Alex Samuelson** declined to comment.

Floating rates on the utility's bonds fell to as little as 1 percent to 2 percent from 2002 to 2004, while the utility was paying AIG 6.2 percent. Until mid-2008, Snohomish paid AIG a net $25.7 million, court filings show.

Demand for the bonds dried up during the 2008 **credit crisis**. The lack of liquidity was so severe it was likely to trigger a provision of the contract that, AIG said, would limit its own payments to the utility to an amount based on international bank rates. The power company would have to pay the higher floating rates, resulting in $5 million of additional annual costs.

Buying Back

Utility bond counsel **William Doyle** told Snohomish commissioners at a board meeting in September 2008 that they should buy back the bonds and put them into a trust. That would force AIG, then in the midst of a government bailout that totaled $182.3 billion, to pay the floating rate.

AIG's lawyers questioned whether the arrangement was permissible under the bond agreements during a conference call. Doyle, of the firm of Orrick, Herrington & Sutcliffe LLP in San Francisco, "cut off the question," according to AIG's court filings. He declined to comment. The trust purchased the bonds in October 2008.

In July, AIG sued the utility in New York state court, saying the refinancing breached the swap agreement because the 58-page document required "written consent" from AIG for any purchase of the bonds. Snohomish then filed its suit against AIG in federal court, and the cases were consolidated in Seattle. The settlement disposes of it.

Citigroup was the senior underwriter of this week's debt sale. The utility also added a co-manager, Barclays Plc, said Herrling, Snohomish's financing manager.

"When you have two desks working your deal, you're making sure you've got some checks and balances there," he said.

The case is Public Utility District No. 1 of Snohomish County, Washington, v. AIG Financial Products Corp., U.S. District Court for the Western District of Washington (Seattle).

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